



**FannieMae**

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Financial Accounting Standards Board  
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Dear Ms. Bielstein:

Fannie Mae appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB's) Exposure Draft of the proposed Statement of Financial Accounting Standards, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (ED). While the ED incorporates appropriate guidance on loan commitments cleared in Statement 133 Implementation Issue C13 – *When a Loan Commitment is Included in the Scope of Statement 133* and beneficial interests provided in Statement 133 Implementation Issue C17 – *Scope Exceptions: Application of the Exception in Paragraph 14 to Beneficial Interests that Arise in a Securitization*, we believe there are two significant weaknesses in the ED:

- First, the ED fails to correct inconsistencies in the current accounting for purchased options that produce misleading results.
- Second, the proposed modification to the definition of financial guarantee contracts may inappropriately scope many guarantee contracts into FAS 133, including our guarantee of off-balance sheet mortgage-backed securities (MBS) that totaled \$896 billion at March 31, 2002, even though analogous insurance contracts are exempt from FAS 133.

The Board's objective in amending FAS 133 was to improve financial reporting by creating more consistency in the reporting of financial contracts. One of the FASB's principal tenets of high-quality financial reporting set forth in its mission statement is that similar transactions should be accounted for in a similar manner. However, the proposed amendment has failed to correct inconsistencies in the current accounting for purchased options and would potentially create inconsistencies between the accounting for financial guarantees and insurance contracts.

We noted that Standard & Poor's (S&P) recently decided to exclude unrealized gains and losses on hedging-related derivatives from its definition of "core earnings." One of the reasons S&P

developed its definition of core earnings was to improve consistency in reporting and reduce investor frustration. We strongly urge the FASB to keep these views from the financial statement user community on FAS 133 in mind during the balance of the amendment process. We believe adoption of our proposed accounting solution for purchased options and our suggested corrections to the definition of financial guarantees would significantly improve the consistency and value of FAS 133 accounting results. In addition, it would help return GAAP earnings to its previous position as the preeminent barometer of financial performance.

### **Accounting for Purchased Options**

Fannie Mae believes that the accounting for purchased options used as hedges under FAS 133 has two critical shortfalls:

- It creates misleading earnings volatility that does not reflect the economics of our hedging strategy for purchased options.
- It generates inconsistent accounting results that differ depending on the type of purchased option and how it is used as a hedge.

To compensate for these deficiencies, Fannie Mae was forced to adopt supplementary non-GAAP measures—"operating net income" and "operating EPS"—to eliminate the earnings volatility associated with accounting for purchased options under FAS 133 and provide investors with more relevant information to assess the impact of hedges with purchased options on our operating performance and financial condition. These measures exclude the change in time value of purchased options recorded under FAS 133 and reflect what earnings would have been had we continued amortizing the cost of purchased options over the life of the option as we had done prior to the adoption of FAS 133. Investors and analysts have embraced these measures, uniformly agreeing that they are more indicative of Fannie Mae's operating performance and are better tools in assessing Fannie Mae's core earnings.

### ***Misleading Earnings Volatility***

Purchased options are a critical tool that Fannie Mae uses to match the durations of our liabilities with the durations of our mortgage assets, which contain embedded options. Under FAS 133, we are required to recognize unrealized changes in the time value of purchased options used as hedges in earnings. Yet, we never realize the mark-to-market gains or losses on these options during their lives because we do not trade them. Given the held-to-maturity nature of these derivatives and the fact that they are used in combination with debt to hedge held-to-maturity assets, our GAAP earnings do not accurately reflect the economics of our hedging activities. Furthermore, the fact that only a portion of our assets and liabilities are being marked to market through earnings (time value of options component) makes it virtually impossible for the average investor to assess our risk position and future earnings potential.

Fannie Mae has recorded substantial swings in the time value of purchased options since adopting FAS 133, even though we hold the options to maturity. The changes in time value produce GAAP earnings that do not reflect our financial performance, and the financial press has made erroneous conclusions about our earnings trends that were particularly troublesome in the

first quarter of 2002. The following table evidences the wide disparity between the change in time value of options under FAS 133 and the straight-line amortization of purchased options premiums under pre-FAS 133 accounting and the impact it has had on our GAAP net income versus our operating net income (adjusted for the changes in time value and the cumulative effect of adopting FAS 133) since the adoption of FAS 133.

<i>(in millions)</i>	<b>2001 Q1</b>	<b>2001 Q2</b>	<b>2001 Q3</b>	<b>2001 Q4</b>	<b>Full Year 2001</b>	<b>2002 Q1</b>
<b>GAAP Results</b>						
After-tax changes in time value	\$ (154)	\$ 23	\$ (269)	\$ 376	\$ (24)	\$ (512)
Net income	1,293	1,402	1,230	1,969	5,894	1,209
<b>Operating Results</b>						
After-tax straight-line amortization expense	\$ (42)	\$ (65)	\$ (121)	\$ (155)	\$ (383)	\$ (202)
Operating net income	1,238	1,314	1,376	1,438	5,367	1,519
<b>Difference in Income Results<sup>1</sup></b>	<b>55</b>	<b>88</b>	<b>(146)</b>	<b>531</b>	<b>527</b>	<b>(310)</b>

<sup>1</sup> Represents the difference between GAAP net income and operating net income. In first quarter 2001, we recognized \$168 million in income from the adoption of FAS 133 that we excluded from operating net income.

In the first quarter of 2002, Fannie Mae's operating net income totaled \$1.519 billion, an increase of \$281 million, or 23 percent, over the same prior year period. In contrast, our GAAP net income decreased \$84 million, or 6 percent, from the same prior year quarter because of a \$458 million increase in unrealized losses recorded on purchased options. Although we have spent considerable resources educating analysts and investors on our operating earnings results and we emphasize this performance measure in our earnings releases, several news agencies published headlines and articles that grossly misrepresented our performance to investors:

- "Fannie Mae Profit Slides by 6.5%, Hurt by Changes in Accounting"<sup>1</sup>
- "Fannie Mae Earnings Fell 6% in Quarter"<sup>2</sup>
- "Roundup: FAS 133 Takes a Bite Out of Fannie Mae's Earnings"<sup>3</sup>
- "Fannie Mae Blames Decline on Mark-to-Market Rule"<sup>4</sup>

Similarly, there were distorted headlines that misrepresented the performance of Freddie Mac, another major user of purchased options:

- "Freddie Mac Posts Increase of 69% in Quarterly Net"<sup>5</sup>
- "Freddie Mac Profit Rose by 69% Helped by Accounting Rule"<sup>6</sup>
- "Freddie Mac's Profit Net Soared 69%"<sup>7</sup>

<sup>1</sup> "Fannie Mae Profit Slides by 6.5%, Hurt by Changes in Accounting," *The Wall Street Journal*, 16 April 2002.

<sup>2</sup> "Fannie Mae Earnings Fell 6% in Quarter," *The Washington Post*, 16 April 2002.

<sup>3</sup> "Roundup: FAS 133 Takes a Bite Out of Fannie Mae's Earnings," *National Mortgage News*, 22 April 2002.

<sup>4</sup> Tommy Fernandez, "Fannie Mae Blames Decline on Mark-to-Market Rule," *American Banker*, 16 April 2002.

<sup>5</sup> "Freddie Mac Posts Increase of 69% in Quarterly Net," *The Wall Street Journal*, 24 April 2002.

<sup>6</sup> "Freddie Mac Profit Rose by 69% Helped by Accounting Rule," *The Wall Street Journal Europe*, 25 April 2002.

<sup>7</sup> "Freddie Mac's Profit Net Soared 69%," *The Asian Wall Street Journal*, 25 April 2002.

One prominent investment analyst commenting on these articles stated, "I don't think anyone in the investment community is giving any serious credence to FAS 133. . . it's meaningless because of its inaccuracy. The way that FAS 133 is applied to the mortgage industry, and Fannie and Freddie in particular, distorts their results."<sup>8</sup> At a time of widespread investor confusion and distrust in the reliability of corporate earnings, we are concerned the GAAP earnings volatility that results from applying FAS 133 to purchased options could lead uninformed financial statement users to draw erroneous conclusions about our financial performance. S&P, in adopting its core earnings measure, recognized this distortion and appropriately excluded unrealized gains and losses on hedging-related derivatives from its definition of core earnings.

### ***Inconsistent Accounting Results***

The chart below summarizes the current purchased options accounting treatment under FAS 133, which varies depending on the option used or hedging strategy. The derivative transactions below mirror the economics of callable debt.

Type of Option	Accounting Treatment for Option Premium
Callable debt	<ul style="list-style-type: none"> <li>▪ Expense recognized in the interest rate on a level-yield basis over the option period.</li> </ul>
Cash flow hedges with European-style options (G20) where hedged item is issuance of fixed-rate debt.	<ul style="list-style-type: none"> <li>▪ Expense recognized ratably over the life of the hedged item. No time value expense recognized during the option period.</li> </ul>
Cash flow hedges with European-style options (G20) where hedged item is future cash flows on variable-rate debt.	<ul style="list-style-type: none"> <li>▪ Change in time value recognized during option period on a mark-to-market basis.</li> </ul>
Cash flow hedges with American-style options (assuming time value is excluded from hedge effectiveness test)	<ul style="list-style-type: none"> <li>▪ Change in time value recognized during option period on a mark-to-market basis.</li> </ul>
Fair value hedges with options (assuming time value is excluded from hedge effectiveness test).	<ul style="list-style-type: none"> <li>▪ Change in time value recognized during option period on a mark-to-market basis.</li> </ul>

These multiple methods of accounting for purchased options have made it even more difficult for investors and analysts to understand the impact of purchased options on a company's financial performance.

### ***Recommended Proposal to Change the Accounting for Purchased Options***

Where entities have the positive intent and ability to hold purchased options to maturity, Fannie Mae recommends that the premiums paid be amortized into earnings over the life of the option. Under these circumstances, we believe the purchased option premium is akin to insurance

<sup>8</sup> Kyriaki Venetis, "Fannie Earnings Grow, But Increase Is Slowed by FAS 133," *Origination News*, 24 May 2002.

against the risk of changes in interest rates. Thus, the cost of that premium should flow through earnings on a level basis over the period that we have coverage or protection. We also propose that the difference between the unamortized option premium paid and the fair value associated with the time value component of the option be recorded as a component of other comprehensive income (OCI). Additionally, we recommend that entities disclose information about material investments in purchased options, such as cost, term, exercise date(s), and usage of purchased option contracts.

From a cost-benefit perspective, we believe there are several notable benefits of our proposal, with few, if any costs, including:

- *Greater consistency in the accounting for options* – Our approach fulfills the FASB’s objective because purchased options on both cash flow and fair value hedges would be accounted for in a similar manner and would be more consistent with the accounting treatment of callable debt premiums.
- *Enhanced investor disclosures* – Recognition of the decay of time value would be recorded in OCI so that it is easily identifiable by investors.
- *Elimination of excess capital requirements* – Fannie Mae currently has to carry excess capital because the mark-to-market on purchased options flows through earnings without a corresponding offset from the prepayment options in our mortgage portfolio. Fannie Mae expects to hold approximately \$1 billion in excess capital during 2002 to protect against adverse swings in the market value of our purchased options. This economic cost would be eliminated under our proposal.

Fannie Mae therefore requests that the Board incorporate our proposal in the amendment to FAS 133.

### **Financial Guarantee Contracts**

Fannie Mae is concerned that the proposed modification to paragraph 10(d) could be interpreted to scope financial guarantee contracts into FAS 133. In attempting to clarify the FAS 133 exemption for financial guarantee contracts, we believe the ED would introduce confusion and an unwarranted inconsistency between the accounting for financial guarantee contracts and insurance contracts that contradicts principles outlined in FAS 133 and Statement 133 Implementation Issue C7 – *Scope Exceptions: Certain Financial Guarantee Contracts (C7)*. The language in the basis for conclusions in the ED could lead one to conclude that most financial guarantees should be now included in the scope of FAS 133.

### ***Fannie Mae MBS Guarantee***

Fannie Mae issues MBS to help foster additional investment in mortgages by disseminating the risk associated with holding mortgage loans throughout the marketplace. Fannie Mae enhances the liquidity of MBS and the marketability of mortgage assets by guaranteeing the timely payment of principal and interest (P&I) to MBS investors. Fannie Mae receives a guarantee fee for assuming the credit risk on loans underlying an MBS. Below is an overview of how MBS are created as well as the rights and responsibilities of participants:

- A lender transfers loans into a Fannie Mae MBS trust. The MBS trust issues certificates, which are then provided to the lender in exchange for the loans.
- On behalf of investors, the trust hires Fannie Mae to guarantee timely payment of P&I on the loans to investors. Fannie Mae receives a fixed, monthly guarantee fee on the MBS based upon the pool product mix. The guarantee fee amount on an MBS pool is a function of the pre-determined monthly guarantee fee rates multiplied by the unpaid principal balance of the loans in the trust. ***The trust is the legal beneficiary (guaranteed party) of Fannie Mae's guarantee, which inures to the benefit of MBS investors.***
- On behalf of investors, the trust hires a servicer that is responsible for actively collecting and processing loan payments. Servicing fees are the product of a servicing fee multiplied by the unpaid principal balance of the loans in the trust. ***The trust and its investors are the beneficiaries with respect to the servicer's collection of P&I.***
- A borrower makes monthly P&I loan payments to the servicer, and the servicer transfers these payments to the trust. The guarantee and servicing fees are deducted from the loan payments and reduce P&I cash flows to investors in the MBS trust.
- If a borrower misses a payment, the servicer will attempt to collect the delinquent payment and Fannie Mae will make the delinquent P&I payment to the investor on behalf of the trust.
- The guaranteed parties (i.e., trust and investors) do not demand payment from the borrower. Typically, they are not aware that a default has occurred.
- Once Fannie Mae advances payment under the guarantee agreement, the guaranteed party subrogates its rights to the delinquent payment to Fannie Mae. If a borrower cures a default, Fannie Mae retains the P&I payments as reimbursement of the amounts advanced under the guarantee agreement.

### ***Application of ED***

The proposed amendment to paragraph 10(d) and the basis for conclusions (paragraphs A29 and A30) provide conflicting guidance on how to account for guarantees. Proposed paragraph 10(d) clearly contrasts between financial guarantees that are similar to insurance and exempt from FAS 133 versus contracts that provide for payments based upon a change in an underlying rate that are subject to FAS 133. Under the revised paragraph 10(d), we would continue to conclude that our MBS guarantee would not be subject to FAS 133 because the mortgage borrower has not fulfilled its obligation to make payments and the servicer has notified the borrower that it is in default of the mortgage contract until the delinquency payment is made. However, the basis for conclusions outlines some general principles to determine whether a guarantee contract is eligible for the scope exception in paragraphs A29 and A30 that could lead to an opposite conclusion:

- The guaranteed party must demand payment and attempt collection from the debtor prior to collecting any payment from the guarantor.
- The guarantor must receive delivery of the defaulted receivable upon an event of default.

A literal interpretation of this language would mean that Fannie Mae's MBS guarantee contracts do not qualify for exemption from FAS 133 because the guaranteed parties (trust and investors) do not directly demand payment from the borrower, and Fannie Mae as guarantor does not

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immediately take delivery of the mortgages upon an initial default. The language in paragraphs A29 and A30 would be in direct conflict to the Board's intention that the exception for financial guarantee contracts under FAS 133 be similar to the exception for insurance contracts (paragraph A30 of the ED). Insurance contracts were scoped out of FAS 133 because "definitional and valuation difficulties still existed" (paragraph 278 of FAS 133). Insurance contracts were excluded from the definition of a derivative if "they entitle the holder to compensation only if, as a result of an identifiable insurance event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk" (paragraph 281 of FAS 133). The Board states in paragraph A30 that guarantees of this type are eligible for the scope exception because they are similar to insurance contracts. In addition, the proposed language conflicts with Issue C7 in that the compensation paid to MBS investors under the guarantee does not exceed the loss incurred by MBS investors.

### ***Recommended Changes for Financial Guarantee Exception***

We urge the Board to modify the guidance for financial guarantees such that it clearly aligns with the definition of insurance contracts that are exempted from FAS 133. This appears to have been the Board's intent when developing FAS 133 as well as this ED. Financial guarantee contracts have similar economic characteristics to insurance contracts, and they should receive similar treatment under FAS 133. Many insurance contracts are exempted from FAS 133, yet the insured party does not first attempt to collect for damages from a third party prior to receiving reimbursement from the insurer, nor does the insurer necessarily take possession of damaged property. The fact that the guaranteed parties in our MBS have hired other parties to collect and to guarantee the timely payment of P&I should not preclude an exemption from FAS 133 for our MBS guarantee. Similar to insurance contracts, we believe that financial guarantees should be exempted from FAS 133 when "they entitle the holder to compensation only if, as a result of an identifiable insurance event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk" (paragraph 281 of FAS 133).

We hope that FASB uses the amendment process to evaluate our suggested change in the accounting for options and to clarify the definition of a financial guarantee such that FAS 133 produces more meaningful results than proposed in the ED. The usage of purchased options as hedges and the MBS guarantee are two critical elements of our business, so we would be pleased to discuss any aspect of our positions with the FASB and provide further assistance in your re-deliberations on the ED.

Sincerely,

Jonathan Boyles